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Farmer Cooperatives and Federal Income Taxes: Is Exempt Status More Beneficial?

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C. DAVID HOLLIS AND CHARLES H. INGRAHAM

INTRODUCTION

Farmer cooperation in the United States dates back to colonial days when farmers helped each other harvest crops, erect buildings, clear land, and build roads. When farmers began producing more than was required for subsistence, cooperative efforts were initiated to market the excess production, purchase supplies, and provide needed services. These early, informal efforts have evolved into complex, farmer-owned business organizations encompassing nearly all phases of the present U. S. agricultural economy. In 1966, 28 percent of the United States' farm output was marketed through farmer cooperatives.

Farmer cooperatives are in a unique position with respect to federal income taxation. Two tax statuses are available to farmer cooperatives: exempt and nonexempt. Exempt and nonexempt associations are governed by different operating and organizational requirements. Deductions permitted from taxable income also are different for the two statuses.

For several years these differences have caused cooperative leaders, accountants, and attorneys to discuss and debate the relative merits of each tax status. The particular "advantages" of each status derived from such debate have lacked empirical evidence to substantiate any economic differential. Also, the various "advantages" of the two tax statuses have not been consolidated in such a way as to allow the total ramifications of tax status to be analyzed.

The 48 percent tax rate on corporate income in the United States, along with the different requirements and deductions associated with exempt and nonexempt cooperatives, suggested a need for research into the economic implications of tax status to farmer cooperatives. This research project focused on such an analysis.

PURPOSE AND OBJECTIVES

The purpose of this study was to prove or disprove the hypothesis that tax exempt status is more economically advantageous than nonexempt status.

Specific objectives of the study were:

- To determine the federal income tax status of farmer cooperatives in Ohio.
- To measure the economic advantages experienced by farmer cooperatives which have qualified for and maintained exempt status as compared to those farmer cooperatives which have not so qualified.
- To develop a decision-making aid which will assist farmer cooperative boards of directors in determining with which tax status to comply.

METHOD OF STUDY

The final plan for the study consisted of three distinct sections: (1) determining the tax status of farmer cooperatives in Ohio, (2) financial analysis of exempt and nonexempt cooperatives, and (3) formulating a decision-making aid for determining optimum tax status.

Tax Status of Ohio Cooperatives

A questionnaire was prepared and used to collect data from 203 cooperative associations for this phase of the study. These 203 associations represent 68.6 percent of the known number of farmer cooperatives engaged in purchasing farm supplies and marketing farm products in Ohio in 1968.

In addition to determining present income tax status, the questionnaire was designed to convey information about the present size and financial structure of each responding organization.

Financial Analysis

A financial analysis, consisting of ratio analysis and comparative balance sheet analysis, was performed on two groups of cooperative elevator and farm supply associations to determine the relative economic advantages of exempt and nonexempt tax status. Financial data for the period 1940 through 1965 were obtained from a previous research study[1] on 21 cooperative associations in Ohio. There were 14 exempt status and 7 nonexempt status organizations in the total group.

Both internal and external standards of comparison were utilized in analyzing the aggregated capital structures and ten selected operating ratios of the two groups. In this way, it was possible to compare each group with its own past performance and to compare the two groups of firms with each other.

[1]Dickey, Ronald W. 1966. An Analysis of Financial Management of Agricultural Cooperative Business Organizations in Ohio and Recommendations for Improvement. Unpublished Ph.D. Dissertation, Department of Agricultural Economics and Rural Sociology, The Ohio State University.

Three assumptions were made in this phase of the study. They were:

1. The capital structure and operating ratios used in the analysis adequately reflect the economic differences between the two tax statuses.
2. Any differences in economic strength and achievement between the two groups is attributable to the income tax status they maintain.
3. Farmer cooperatives in Ohio, as far as capital structure and operating ratios are concerned, are representative of farmer cooperatives throughout the United States.

Financial analyses were also performed on other farmer cooperatives in Ohio. Included were breeding associations, wholesale grain and supply associations, and egg marketing cooperatives. The results of these analyses are not discussed in this publication, however, as they were proved invalid due to the small number of firms involved and a lack of homogeneity in business operations and organizational structures.

Decision-Making Aid

This section of the study is based on findings of the two preceding sections and additional knowledge obtained by the authors. The major organizational and operational characteristics of cooperatives which affect or are affected by tax status are analyzed in this phase of the study. The economic implications so derived form the bases for determining which tax status is best suited to a particular association.

The characteristics analyzed are the ones found through this study to be most important to the decision concerning tax status. This analysis was formulated as a decision-making aid for use by directors of farmer cooperatives in determining the optimum tax status for their association. Formulas, developed by the authors from this investigation, are used wherever applicable.

TABLE 1.—Income Tax Status, by Major Business Activity, 203 Cooperative Associations, Ohio, 1968.

Major Business Activity	Tax Status		
	Exempt	Nonexempt	Total
	No.	No.	No.
Marketing			
Elevator	26	28	54
Dairy Products	13	3	16
Fruit and Vegetable	7	4	11
Livestock	3	1	4
Egg and Poultry	0	6	6
Miscellaneous	0	5	5
Supply			
Elevator	16	32	48
Fruit and Vegetable	1	0	1
Artificial Insemination	1	2	3
Miscellaneous	2	4	6
Marketing and Supply			
Elevator	34	15	49
Total	103	100	203
Percent of Total	51	49	100

Source: Original data.

TAX STATUS OF OHIO COOPERATIVES

Number and Major Business Activities

The 203 cooperative associations responding to the questionnaire exhibited a wide range of business activities. Associations engaged primarily in marketing farm products were most numerous. Those purchasing farm supplies ranked second and associations performing both activities in equal amounts were least common.

Many associations classified as *marketing* and many classified as *supply* were involved in both activities. Elevators were the most common example of this. The classification was based on the activity which provided the majority of the cooperative's gross business volume. Associations involved in both activities on a nearly equal basis were classified as *marketing and supply.*

Table 1 presents the number of associations in each business classification, according to their income tax status. Fifty-one percent of the associations held exempt status in 1968. The remaining 49 percent were nonexempt.

Cooperative elevators were the most numerous type of business investigated. Of the 203 associations, 151 were elevators. These were associations conducting business directly with farmers and were the only type of business classified as *marketing and supply.* The 184 cooperative elevators operating in Ohio in 1968 accounted for 62 percent of the total farmers' marketing and/or supply cooperatives in the state that year.[2]

The tax status of the 151 cooperative elevators investigated was representative of the entire sample. Seventy-six elevators were exempt and 75 were nonexempt (Table 1).

Slightly more than 20 percent of the 203 associations indicated they had changed tax status at some time (Table 2). The most common change was from exempt to nonexempt status. Nearly three time as many associations made this transition as

[2]Ingraham, Charles H. and C. David Hollis. April 1968. Directory of Ohio Cooperatives. The Ohio State University, Ohio Cooperative Extension Service, and the Ohio Council of Farmer Cooperatives, p. ii.

those which changed their tax status from nonexempt to exempt.

It was not determined whether these changes were made voluntarily or were necessitated by the individual cooperative's business activity. Many of the changes from exempt to nonexempt status could have been caused by failure to comply with the various requirements for exemption.

Gross Business Volume

Gross business volume of each association was categorized into one of five groups. Seventy-five percent of the associations reported gross business volumes less than $3 million. Only 8 percent of the associations had business volumes more than $10 million (Table 3).

Exempt status cooperatives were more evenly distributed among the five categories than were non-exempt cooperatives. Thirty-three exempt associations (32 percent) reported business volumes in excess of $3 million. The number of exempt associations in the largest volume category was more than twice as large as the number of nonexempt associations in the same category.

Nonexempt associations were most predominant in the two smallest volume categories. Eighty--one percent of the nonexempt associations had business volumes less than $3 million dollars. There were only 19 nonexempt associations with gross business volumes in excess of $3 million.

Membership

Membership data were also separated into five categories. The largest number of associations, 59, was in the category with more than 1,000 members. The category with less than 100 members contained only 30 associations, the smallest number (Table 4).

The number of associations in the middle three categories, with a range of 37 to 39, showed no significant variation. Fifty-six percent of the associations were included in these three categories.

Exempt status associations were most prevalent in the two categories of largest membership. Sixty-five exempt associations (63 percent) reported a membership of more than 600 persons. Forty-two percent of the exempt status associations had more than 1,000 members (Table 4).

Nonexempt associations were most prevalent in the smaller membership categories. Of the total nonexempt associations, 69 percent reported having less than 600 members. Only 16 percent of the nonexempt group had more than 1,000 members (Table 4).

Type of Financial Organization

A common method of classifying cooperative organizations is on the basis of whether they are organized with or without capital stock. Such a classification was made for the cooperative associations investigated.

The cooperatives investigated were predominantly organized with capital stock (Table 5). Eighty-four percent of the associations were organized in this way. The remaining 16 percent reported having no capital stock in their capital structure.

TABLE 2.—Number of Associations Which Have Changed Their Income Tax Status, by Present Tax Status and Major Business Activity, 203 Cooperative Associations, Ohio, 1968.

Major Business Activity	Tax Status	
	Exempt	Nonexempt
	No.	No.
Marketing	6	8
Supply	1	20
Marketing and Supply	4	4
Total	11	32

Source: Original data.

TABLE 3.—Gross Business Volume, by Tax Status and Percent of Total Associations, 203 Cooperative Associations, Ohio, 1968.

Gross Business Volume	Tax Status		Total	Percent of Total
	Exempt	Nonexempt		
	No.	No.	No.	
Under $1 Million	23	41	64	32
$1 Million to $2.9 Million	47	40	87	43
$3 Million to $5.9 Million	17	12	29	14
$6 Million to $9.9 Million	5	2	7	3
More than $10 Million	11	5	16	8
Total	103	100	203	100

Source: Original data.

TABLE 4.—Size of Membership, Number and Percentage* of Associations, by Tax Status, 203 Cooperative Asociations, Ohio, 1968.

Members†	Tax Status				Total	
	Exempt		Nonexempt			
No.	No.	%	No.	%	No.	%
Less than 100	13	13	17	17	30	15
100—299	10	10	28	28	38	19
300—599	15	14	24	24	39	19
600—999	22	21	15	15	37	18
More than 1000	43	42	16	16	59	29
Total	103	100	100	100	203	100

*All percentages are rounded to the nearest whole number.

†Comprises members (those entitled to vote for directors) but excludes non-voting patrons.

Source: Original data.

Tax status of the associations showed little correlation with the type of financial organization. Organization with capital stock was more common for exempt than nonexempt associations, but the difference was only 4 percent. Eighteen percent of the nonexempt associations had no capital stock compared to 14 percent of the exempt status associations (Table 5).

TABLE 5.—Type of Financial Organization, Number and Percentage* of Associations, by Tax Status, 203 Cooperative Associations, Ohio, 1968.

Type of Organization	Exempt		Nonexempt		Total	
	No.	%	No.	%	No.	%
Capital Stock	89	87	82	82	171	84
Non-Stock	14	13	18	18	32	16
Total	103	100	100	100	203	100

*All percentages are rounded to the nearest whole number.
Source: Original data.

TABLE 6.—Percent of Total Business With Nonmembers, Number and Percentage* of Associations, by Tax Status, 203 Cooperative Associations, Ohio, 1968.

Percent Business with Nonmembers	Tax Status: Exempt		Nonexempt		Total	
	No.	%	No.	%	No.	%
Less than 10	41	40	23	23	64	32
10—19	13	12	14	14	27	13
20—29	12	12	13	13	25	12
30—39	10	10	10	10	20	10
40—49	27	26	12	12	39	19
More than 50	0	0	28	28	28	14
Total	103	100	100	100	203	100

*All percentages are rounded to the nearest whole number.
Source: Original data.

TABLE 7.—Non-Patronage Income as a Percent of Total Gross Income, Number and Percentage* of Associations, by Tax Status, 203 Cooperative Associations, Ohio, 1968.

Percent of Non-Patronage Income to Total Gross Income	Tax Status: Exempt		Nonexempt		Total	
	No.	%	No.	%	No.	%
Less than 5	95	92	82	82	177	88
5—9	4	4	4	4	8	4
10—19	1	1	8	8	9	4
More than 20	3	3	6	6	9	4
Total	103	100	100	100	203	100

*All percentages are rounded to the nearest whole number.
Source: Original data.

Business with Nonmembers

Many cooperative associations conduct business with persons who are not members of the association. The Capper-Volstead Act limits nonmember business of marketing cooperatives to less than 50 percent of the total value of products handled.

In Ohio, cooperatives incorporated under the Green-Farnsworth Law[3] are permitted to conduct up to 50 percent of their dollar value business with nonmember patrons. Supply cooperatives, however, must limit business with persons who are neither members nor producers of agricultural products to 15 percent of their dollar value business. Organizations not incorporated under the Green-Farnsworth Law may conduct business with anyone.

Nonmember business accounted for less than 10 percent of the total business volume for 32 percent of the cooperatives investigated. Fourteen percent of the associations conducted more than 50 percent of their business with nonmembers (Table 6).

Exempt status associations are permitted to conduct no more than 50 percent of their dollar business volume with nonmembers. Therefore, exempt status associations were not included in this category. More than one-fourth of the exempt associations conducted between 40 and 50 percent of their business with nonmembers. More exempt status associations were in the *less than 10* percent category than in any other. Forty-one associations (40 percent) conducted less than 10 percent of their business with nonmembers.

A substantial number of the nonexempt associations reported doing more than 50 percent of their business with nonmembers. Twenty-eight percent of the nonexempt associations were included in this category. The second largest percentage of nonexempt associations did less than 10 percent of their business with nonmembers. Twenty-three percent of the nonexempt associations were in this category.

Non-Patronage Income

Income derived by a cooperative from sources other than patrons is called non-patronage income. This includes non-operating income, such as interest, rent, dividends, and certain business with the U. S. government.

Nonexempt cooperatives must include non-patronage income for tax purposes. An exempt cooperative, however, can deduct non-patronage income from taxable income provided it is allocated to patrons on a patronage basis.

This type of income was found to be insignifi-

[3]Ohio Revised Code, Title 17, Secs. 1729.01 - 1729.27.

TABLE 8.—Total Assets and Average Total Assets, by Tax Status, 14 Exempt and 7 Nonexempt Status Cooperative Elevator Associations, Ohio, 1940-1965.

	Exempt Status		Nonexempt Status	
Year	Total Assets of Group	Total Assets per Firm	Total Assets of Group	Total Assets per Firm
1940	$ 953,203	$ 68,085	$ 737,183	$105,311
1945	1,777,728	126,980	1,284,165	183,452
1950	4,286,829	306,202	2,802,381	400,340
1955	6,700,632	478,617	3,889,589	555,656
1960	8,735,778	623,984	4,683,329	669,047
1965	9,308,726	664,909	5,501,451	785,922

Source: Original data.

cant for many of the cooperatives investigated (Table 7). Non-patronage income amounted to less than 5 percent of total gross income for 177 (88 percent) of the associations. Only 4 percent of the associations received more than 20 percent of their gross income from these sources.

Some differences were noted between exempt and nonexempt organizations with regard to non-patronage income. Ten percent more of the exempt status organizations were included in the *less than 5* percent category than was true for nonexempt organizations. Fourteen percent of the nonexempt organizations received more than 10 percent of their total income from non-patronage sources, compared to only 4 percent of the exempt status associations (Table 7).

FINANCIAL ANALYSIS

General Information About Elevators Studied

Of the 21 cooperative elevator associations analyzed, 14 held exempt status and 7 nonexempt status. Each organization had maintained its present tax status from 1940 to 1965.

Each association was involved in the grain marketing and farm supply business. Many of the cooperatives employed the same auditing firm and each had similar business operations. Therefore, accounting data were well suited to both internal and external comparisons.

A difference was discovered in the average size of the firms in the two groups. The average size of the exempt organizations was smaller than the average size of the nonexempt organizations throughout the time period under consideration (Table 8). However, this difference became smaller as time progressed. Total assets of the exempt status group increased 876 percent from 1940 to 1965. The nonexempt group increased total assets by only 646 percent during the same period.

The period of largest growth for both groups was from 1940 to 1950. During that time, the exempt

TABLE 9.—Percentage Increases in Total Assets, Net Worth and Total Liabilities, by Tax Status, 21 Cooperative Elevator Associations, Ohio, 1940 to 1950 and 1950 to 1965.

	Tax Status			
	Exempt		Nonexempt	
	1940-50	1950-65	1940-50	1950-65
	Percent	Increase	Percent	Increase
Total Assets	349.7	117.1	280.1	96.3
Net Worth	312.9	80.2	199.3	96.4
Total Liabilities	478.2	209.3	745.2	96.2

Source: Original data.

status group increased total assets nearly 350 percent while the nonexempt group grew by 280 percent (Table 9). The rate of growth was much slower for both groups from 1950 to 1965. Table 9 also shows the important part borrowed capital played in financing the growth of total assets for both groups. Between 1940 and 1950, total liabilities of exempt elevators increased 478 percent while liabilities of nonexempt elevators increased 745 percent. Total liabilities of the exempt and nonexempt elevators increased 209 percent and 96 percent respectively between 1950 and 1965.

Exempt Status Elevators

The various forms of capital making up the aggregated capital structure of exempt status elevators in the investigation fluctuated substantially during the 25-year period. Permanent forms of capital declined from 93.4 percent of total capital in 1940 to 69.1 percent in 1965 (Table 10). During the same period, semi-permanent forms increased rather steadily in importance from 6.6 percent in 1940 to 24 percent in 1965. Non-permanent forms of capital were absent from the capital structures of exempt status organizations until 1955.

Table 10 also shows how net worth and total

TABLE 10.—Percentage Distribution of Forms of Capital, Net Worth and Total Liabilities, 14 Exempt Status Cooperative Elevator Associations, Ohio, 1940-1965.

Form of Capital or Funds	1940	1945	1950	1955	1960	1965
			Percent			
Permanent Capital	93.4	76.3	85.3	80.6	71.6	69.1
Semi-permanent Capital	6.6	23.7	14.7	16.8	20.2	24.0
Non-permanent Capital	0.0	0.0	0.0	2.6	8.2	6.9
Total Capital	100.0	100.0	100.0	100.0	100.0	100.0
Net Worth	77.7	77.6	71.4	69.8	56.8	59.2
Total Liabilities	22.3	22.4	28.6	30.2	43.2	40.8
Total Assets	100.0	100.0	100.0	100.0	100.0	100.0

Source: Original data.

liabilities of exempt status organizations have changed over the 25-year period. The most significant change occurred between 1950 and 1965. Ownership interest in the exempt status elevators decreased from 71.4 percent of the total assets in 1950 to only 59.2 percent in 1965. Total liabilities represented 40.8 percent of total assets in 1965.

The operating ratios calculated for exempt status organizations are presented in Table 11. As Table 11 shows, all ratios except net sales to total assets weakened from 1950 through 1965. Net sales to total assets remained stable. The general trend of the ratios is based on internal comparison only. Thus, the exempt status organizations have shown a definite weakening trend compared to their past performance.

Previous research on financing farmer cooperatives yielded industry standards for cooperative elevator and farm supply associations.[4] These standards are presented in Table 12 for purposes of external comparison.

During the period 1950 through 1965, only four of the exempt status organizations' ratios were within the ten selected standards. The four ratios in the accepted range were: (1) age of total receivables, (2) total expenses to net sales, (3) net sales to total assets, and (4) net savings to net worth.

Based on the selected industry standards, the exempt status group of elevators were not the most successful firms in their industry.

Nonexempt Status Elevators

The nonexempt status group of elevators also experienced substantial changes in the composition of their aggregate capital structure. Permanent forms of capital decreased from 95.3 percent of total capital in 1940 to 75.4 percent in 1965 (Table 13). The major portion of this change, however, occurred between 1940 and 1950. From 1950 to 1965, permanent forms of capital, as a percentage of total capital, decreased only 2 percent.

[4] Burkes, Marshall R. 1962. Changes in the Financial Strength and Structure of Agricultural Business Organizations. Unpublished Ph.D. Dissertation, Department of Agricultural Economics and Rural Sociology, The Ohio State University, pp. 60-62.

TABLE 11.—Operating Ratio Analysis, 14 Exempt Status Cooperative Elevator Associations, Ohio, 1950-1965.

Ratio	1950	1955	1960	1965	General Trend*
Current Ratio	1.94 to 1	2.05 to 1	1.55 to 1	1.54 to 1	—
Total Receivables of Current Assets	28.32 %	50.44 %	56.95 %	59.43 %	—
Net Supply Sales to Total Receivables	11.02 to 1	5.62 to 1	4.37 to 1	4.49 to 1	—
Age of Total Receivables	32.8 days	42.2 days	53.5 days	47.7 days	—
Net Worth to Total Debt	2.49 to 1	2.31 to 1	1.32 to 1	1.45 to 1	—
Total Expenses to Net Sales	9.82 %	10.15 %	11.45 %	10.05 %	—
Net Savings to Net Sales	2.28 %	2.82 %	1.37 %	1.41 %	—
Net Sales to Total Assets	3.72 times	3.54 times	2.99 times	3.52 times	=
Net Savings to Total Assets	8.47 %	9.99 %	4.11 %	4.97 %	—
Net Savings to Net Worth	12.91 %	14.32 %	7.23 %	8.39 %	—

*General Trend: + Strength; = Stability; — Weakness.
Source: Original data.

TABLE 12.—Industry Standards for Local Cooperative Elevator and Farm Supply Associations.

Ratio	Standard		
Current Ratio	2.5 to 1	—	3.5 to 1
Total Receivables of Current Assets	33 1/3 %	—	50.0 %
Net Supply Sales to Total Receivables	6.0 to 1	—	10.0 to 1
Age of Total Receivables	30.0 days	—	60.0 days
Net Worth to Total Debt	2.0 to 1	—	3.0 to 1
Total Expenses to Net Sales	6.0 %	—	11.0 %
Net Savings to Net Sales	2.0 %	—	3.0 %
Net Sales to Total Assets	3.0 times	—	5.0 times
Net Savings to Total Assets	6.0 %	—	10.0 %
Net Savings to Net Worth	8.0 %	—	15.0 %

Source: Burkes, Marshall R. 1962. Changes in Financial Strength and Structure of Agricultural Business Organizations. Unpublished Ph.D. Dissertation, Department of Agricultural Economics and Rural Sociology, The Ohio State University, pp. 60-62.

TABLE 13.—Percentage Distribution of Forms of Capital, Net Worth and Total Liabilities, Seven Nonexempt Status Cooperative Elevator Associations, Ohio, 1940-1965.

Form of Capital or Funds	1940	1945	1950	1955	1960	1965
			Percent			
Permanent Capital	95.3	88.3	77.6	71.7	74.5	75.4
Semi-permanent Capital	0.0	6.5	9.4	13.7	19.4	23.6
Non-permanent Capital	4.7	5.2	13.0	14.6	6.1	1.0
Total Capital	100.0	100.0	100.0	100.0	100.0	100.0
Net Worth	85.2	74.0	67.1	61.2	62.9	67.1
Total Liabilities	14.8	26.0	32.9	38.8	37.1	32.9
Total Assets	100.0	100.0	100.0	100.0	100.0	100.0

Source: Original data.

TABLE 14.—Operating Ratio Analysis, Seven Nonexempt Status Cooperative Elevator Associations, Ohio, 1950-1965.

Ratio	1950	1955	1960	1965	General Trend*
Current Ratio	2.76 to 1	2.48 to 1	2.80 to 1	2.26 to 1	—
Total Receivables of Current Assets	31.56 %	37.23 %	32.98 %	34.3 %	=
Net Supply Sales to Total Receivables	9.53 to 1	7.61 to 1	7.58 to 1	6.03 to 1	—
Age of Total Receivables	33.0 days	20.7 days	38.4 days	29.7 days	=
Net Worth to Total Debt	2.04 to 1	1.58 to 1	1.69 to 1	2.04 to 1	—
Total Expenses to Net Sales	7.32 %	7.88 %	9.43 %	9.83 %	—
Net Savings to Net Sales	4.21 %	2.85 %	1.85 %	1.39 %	—
Net Sales to Total Assets	4.28 times	4.04 times	3.54 times	3.49 times	—
Net Savings to Total Assets	18.03 %	11.53 %	6.57 %	4.85 %	—
Net Savings to Net Worth	26.92 %	18.75 %	10.43 %	7.23 %	—

*General Trend: + Strength; = Stability; — Weakness.
Source: Original data.

Semi-permanent forms of capital, as a percentage of total capital, increased steadily over the 25-year period. These forms of capital, appearing for the first time in 1950, increased from 6.5 percent of total capital that year to 23.6 percent in 1965.

Non-permanent forms of capital fluctuated greatly throughout the 25-year period. In 1965, non-permanent capital amounted to only 1 percent of total capital in the nonexempt organizations, down from a high of 14.6 percent in 1955.

Table 13 also shows the distribution between net worth and total liabilities of the nonexempt group of elevators. Over the entire time period, 1940 to 1965, net worth declined relative to total liabilities. The most significant change occurred between 1940 and 1950 when net worth declined from 85.2 to 67.1 percent of total assets. Net worth remained between 61.2 percent and 67.1 percent of total assets from 1950 through 1965.

Operating ratios of the nonexempt group exhibited a general weakening trend during the 15-year period. Only two ratios, total receivables of current assets and age of total receivables, were stable; the other eight ratios weakened (Table 14). From this, it was concluded that the nonexempt group of elevators had weakened in relation to their past performance.

Five of the ten ratios calculated for the nonexempt group of cooperative elevators were within the range prescribed by the selected industry standards throughout the period investigated (Table 14). The ratios within the acceptable range were: (1) total receivables of current assets, (2) net supply sales to total receivables, (3) age of total receivables, (4) total expenses to net sales, and (5) net sales to total assets.

One other ratio, net worth to total debt, was within the standard range in two of the four time periods. In both 1950 and 1965, the net worth to total debt ratio was 2.04 to 1—within the selected industry standard. This ratio was below the industry standard in both 1955 and 1960.

Comparing the Two Groups

Comparison between the aggregated balance sheet data and operating ratios of the two groups of elevators indicated that, as a group, the elevators maintaining nonexempt status experienced more economic success than those maintaining exempt status. Net worth was maintained at higher and more stable levels by the nonexempt group (Tables 10 and 13). In addition, operating ratios of the nonexempt group were generally higher and more acceptable than those of the exempt group (Tables 11 and 14).

The superiority of the nonexempt group did not, however, extend to all firms in that group. Further investigation showed that there were equally successful firms in each group. Likewise, both the exempt and the nonexempt groups contained firms which were relatively unsuccessful. The proportion of successful firms in each group was nearly equal.

Thus, on an individual firm basis, it cannot be shown that economic success has been directly dependent on nonexempt income tax status. The result obtained from analyzing the two groups of elevators was a statistical phenomenon arising from aggregating data on individual firms. While the nonexempt elevators as a group exhibited better performance, there were equally successful firms in each tax status.

DECISION-MAKING AID

As shown in the preceding section, both exempt and nonexempt status cooperatives are economically successful. Close inspection revealed that the more successful firms maintained the tax status best suited to their particular organizational and operational characteristics. As these characteristics were dissimilar, so was the tax status maintained.

This section reviews the characteristics of a cooperative found to be the most significant in determining the more beneficial tax status for a particular association. These characteristics are important decision areas for cooperatives attempting to determine the more beneficial tax status for their situation.

Member-Nonmember Business

One area which must be examined when making a decision on tax status concerns the distribution of total business volume between members and nonmembers. Exempt status associations are required to treat members and nonmembers equally. Therefore, patronage refunds, when declared, must be paid to both members and nonmembers.

Nonexempt associations are permitted to limit patronage refunds to members only. After income taxes are paid on earnings from nonmember business, nonexempt cooperatives can retain these funds as tax-paid surplus. Thus, nonexempt cooperatives can, by this method, increase permanent capital through business conducted with nonmembers.

The right to limit patronage refunds to members is one of the major advantages of nonexempt status. The economic significance attached to this privilege depends, however, on the proportion of total business conducted with nonmembers. The larger the proportion of nonmember business, the more significant are the economic gains derived from restricting patronage refunds to members. Associations not conducting business with nonmembers would not derive economic gain from this privilege. Associations with a large proportion of nonmember business could obtain substantial amounts of permanent capital from this right.

When patronage refunds are restricted to members, no records are required to be kept on nonmember business. The savings in record-keeping costs resulting from this also depend on the proportion of total business conducted with nonmembers. When the proportion of nonmember business is small, only slight savings in record-keeping costs can be obtained. If the proportion is large, these costs can be reduced substantially.

The proportions of nonmember and nonmember-nonproducer business which can be conducted by an exempt status association are limited by law to 50 percent and 15 percent respectively of the total dollar volume. Cooperatives operating outside of these limits must either maintain nonexempt status or revise their operations to qualify under the law. By limiting nonmember and nonmember-nonproducer business to the extent required for exempt status, some associations would cease to be a profitable-size business operation. For these associations, nonmember business is essential for continued business with member patrons.

Nonexempt cooperatives are permitted to deduct, from taxable income, patronage refunds paid to nonmembers. If this is done, complete records must be kept on all patronage. In such cases, no economic advantage is achieved by operating under nonexempt status.

The actual dollar amount of gain achieved by limiting patronage refunds to members is easily calculated for an individual association. Using the applicable income tax rate for a given association, the amount which could be added to surplus in any particular year is:

$$(1.00 - \text{Tax Rate}) \times \text{Earnings from Nonmember Business}$$

In addition, the proportion of record-keeping costs associated with nonmember business would be eliminated.

If an association is presently paying patronage refunds to members only, the record-keeping savings would be reflected in earnings from nonmember business. The former situation applies to an exempt association contemplating changing to nonexempt status, while the latter applies to an association presently holding nonexempt status.

Type of Financial Organization

Another important area which must be considered is whether an association is organized with or without capital stock. Exempt status associations are permitted to deduct from taxable income the dividends they pay on capital stock. Nonexempt associations pay dividends from net income after taxes. In either case, persons receiving the dividends are subject to taxes on the amounts received. Thus, stock dividends of exempt associations are only taxed once; dividends of nonexempt associations are taxed in the same way as regular corporate dividends.

If an association has no capital stock, the allowable deduction under exempt status is meaningless. Such an association would derive no economic gain in this area by qualifying for exempt status.

Associations having capital stock can derive a substantial economic advantage from paying tax-free dividends. The actual value of this deduction depends on the amount of capital stock, the dividend rate, and the proportion of capital stock bearing a fixed dividend requirement.

Preferred stock typically bears a specified rate which must be paid when a dividend is declared. Other rights may be attached to preferred stock, depending on the contract under which it is issued. Dividends on preferred stock must be paid before those on common stock. The dividend rate on common stock is set by the board of directors when a dividend payment is declared.

It is generally considered a good financial practice to declare dividends on capital stock regularly. This is especially important in cooperative associations as stock in these associations has very little potential for growth in value.

The economic advantage of being able to deduct dividends from taxable income can be calculated rather easily if certain facts are known. Given the appropriate income tax rate for the association in question and amount of dividends paid, the formulas for solution are:

$$(1.00 - \text{Tax Rate}) \times Y = \text{Dividends Paid} \quad (1)$$

$$Y - \text{Dividends Paid} = \text{Amount of Tax Saved} \quad (2)$$

where $Y =$ the amount of before-tax income required to pay the dividends

The figure arrived at by the above formulas represents the amount which would have been paid in income taxes if the association had maintained nonexempt status. By maintaining exempt status, an association would have this amount to distribute to patrons or retain as surplus after paying the necessary tax.

This aspect of the total problem is an important consideration, as associations with large amounts of capital stock have found it difficult to maintain both dividend payments and patronage refunds. This problem can be especially difficult for a nonexempt status association.

In addition, operating under nonexempt status would cause some cooperatives to come under regulation of the Securities Act of 1933. The expenses involved in complying with the registration and prospectus requirements of this Act depend on the frequency of securities distributions and the amount of securities issued. These expenses must be estimated and weighed as a negative factor of nonexempt status.

Non-Patronage Income

Income derived by a cooperative association from rents, interest, dividends on investments, and other non-operating sources is referred to as non-patronage income. Exempt status associations are permitted to deduct these amounts from taxable income, provided they are allocated to patrons. Nonexempt associations are required to include non-patronage income in taxable income. After the tax is paid on these amounts, nonexempt associations can retain the remaining portion or distribute it to patrons.

The economic significance of this allowable deduction depends on the proportion of total income derived from non-patronage sources. As discovered in this research, many cooperatives in Ohio derive only a small percentage of their total income from these sources. Thus, the possible economic gain is small in most cases.

If non-patronage income is allocated to patrons, exempt status associations experience an advantage over nonexempt associations. By maintaining exempt status, an association can allocate the full amount of non-patronage income. A nonexempt association can allocate only the amount left after income taxes. That amount is:

(1.00 — Tax Rate) x Non-Patronage Income

Assuming that each type of association paid only the required 20 percent in cash, exempt status associations could retain 80 percent of the full amount of non-patronage income as semi-permanent or non-permanent capital. A nonexempt status association could only retain 80 percent of the amount left after income taxes. In this case, the extra amount which an exempt status association could retain as semi-permanent capital is:

0.8 x Tax Rate x Non-Patronage Income

When non-patronage income is not allocated to patrons, no economic advantage is derived from the extra deduction afforded exempt status associations. In this case, both types of associations must include all non-patronage income in taxable income.

Size of Net Income and Tax Structure

The size of a cooperative association's net income is an important consideration in determining the appropriate tax status. In 1968, the corporate income tax rate was 22 percent on taxable income of less than $25,000. Tax rate on income in excess of $25,000 was 48 percent. In addition, a 10 percent surcharge took effect in 1968.

Since there are two tax rates, the relative significance of deductions varies with the size of taxable income. Deductions are more meaningful when taxable income is more than $25,000 than when it is less than $25,000.

Therefore, exempt status is relatively more advantageous when net income is more than $25,000. The two extra deductions permitted an exempt status association are worth more then than when the lower tax rate is in effect.

Ignoring the surcharge and using the 1968 tax rates, a non-exempt association with taxable income less than $25,000 could pay 78¢ in stock dividends for every $1 of taxable income. For the portion of taxable income more than $25,000, the same association could pay only 52¢ in stock dividends for every $1 of taxable income.

Tax structure also affects this area. As Table 15 shows, corporate tax rates have been changed several times since 1940. As the tax rates have changed, so have the economic implications of tax status. Table 15 shows the tax rate on income more than $25,000. The more recent rates were divided as follows:

Quoted Rate	Normal Rate	Surtax
%	%	%
52	30	22
50	22	28
48	22	26

The normal rate applies to all taxable income and the surtax to taxable income in excess of $25,000.

TABLE 15.—Federal Tax Rates on Corporate Income, 1940-1968.

Income Year	Rate*	Income Year	Rate*	Income Year	Rate*
	%		%		%
1940	24	1950	47	1960	52
1941	31	1951	52	1961	52
1942	40	1952	52	1962	52
1943	40	1953	52	1963	52
1944	40	1954	52	1964	50
1945	40	1955	52	1965	48
1946	38	1956	52	1966	48
1947	38	1957	52	1967	48
1948	38	1958	52	1968	48
1949	38	1959	52		

*This rate applies to taxable income in excess of $25,000.

Source: Pearson Hunt et. al. 1966. Basic Business Finance, Richard D. Irwin, Inc., Homewood, Illinois, pp. 968-987.

Exempt status is relatively more advantageous the higher the prevailing tax rates. When tax rates are low, relatively less economic gain is derived from exempt status.

Additional Business Activities

Exempt status cooperatives are required to limit their business activities to marketing farm products and/or purchasing farm supplies. Other business activities are prohibited. Nonexempt associations are not limited in this way.

Therefore, in deciding which tax status to maintain, an association must weigh the freedom to conduct other business activities as an advantage of nonexempt status. It is not possible to generalize the possible economic effects of this advantage. In the case of a particular association, however, the economic implications of this freedom can be quantified.

To arrive at a decision, projected earnings from the additional business activities need to be calculated. Comparisons can then be made between operating as a nonexempt association with the added business activities and operating within the restrictions imposed on exempt status associations. Decisions involving new or added business activities can be made only by analyzing the complete operation of the association under each tax status.

Effects on Other Cooperatives

A cooperative association's income tax status affects not only its own operations, but also those of cooperatives with which it conducts business. The economic implications of tax status on intercooperative business deserve careful consideration when determining whether to operate as an exempt or nonexempt cooperative.

The first consideration regards payments of patronage refunds and dividends to one cooperative association from another. Tax treatment of such payments at the distributor level is the same as if such payments were made to individuals. Thus, exempt status cooperatives are permitted to deduct both types of payments from taxable income. Nonexempt cooperatives are permitted to deduct patronage refunds from taxable income, but are required to pay dividends from after-tax income.

Tax treatment of patronage refunds at the distributee level depends on the cooperative's tax status and whether the refunds are classified as patronage income or non-patronage income. Regardless of the classification, exempt status cooperatives are permitted to deduct from taxable income the amount of the refund allocated to the association's patrons. Amounts not allocated to patrons are taxable to the cooperative.

If a nonexempt cooperative classifies the refunds as patronage income, it can deduct from taxable income the amount allocated to patrons on a patronage basis, like an exempt cooperative. When classified as non-patronage income, however, a nonexempt cooperative is required to include the full amount of the refund in taxable income.

Therefore, with regard to patronage refunds, neither tax status holds an advantage as long as the refunds are classified as patronage income. Exempt status is more advantageous if the refunds are classified as non-patronage income.

In the case of dividends, tax treatment at the distributee level depends on the tax status of both cooperatives involved. Dividends are a form of nonpatronage income and, as such, are required to be included in the taxable income of nonexempt cooperatives. The amount included is dependent, however, on the tax status of the issuing cooperative. A nonexempt cooperative is required to include in taxable income the full amount of dividends received from exempt status associations. A nonexempt cooperative is permitted an 85 percent dividend credit on dividends received from nonexempt associations. Thus, only 15 percent of the dividends received by a nonexempt cooperative from another nonexempt cooperative are taxable.

Exempt status cooperatives are permitted to deduct from taxable income the dividends received and subsequently allocated to patrons. This is true regardless of the issuing association's tax status. When not allocated to patrons, an exempt status association is required to include dividends so received in its taxable income. Tax treatment in this case is identical to that of a nonexempt association. The full amount received from exempt associations is taxable; only 15 percent of the amount received from nonexempt associations is taxable.

The tax status which is more economically advantageous depends on what use a particular association makes of dividends its receives. If the association plans to allocate the dividends to its patrons, exempt status is more advantageous as the entire amount of dividends can be passed on to patrons without tax at the cooperative level. A nonexempt association can allocate only the amount of the dividends remaining after income taxes.

If the dividends are not allocated to patrons, neither tax status is more economically advantageous than the other. Tax treatment of the dividends is identical for both exempt and nonexempt associations in this case.

Another important consideration in regard to intercooperative business is the *look through* concept. The importance of the *look through* concept lies in its use to determine if federated cooperatives satisfy the nonmember and nonmember-nonproducer business limitations imposed on exempt status associations.

Exempt status members of a federated cooperative qualify as *producers* due to their income tax status. Nonexempt cooperatives which are members of or conduct business with a federated cooperative do not necessarily qualify as *producers* as they are not required to restrict business with nonmembers and nonproducers. Therefore, an exempt status federated cooperative conducting business with both exempt and nonexempt status associations would be subject to the *look through* concept to determine if the requirements for exemption are satisfied. The tax status of a federated cooperative is thus dependent on the tax status of cooperatives with which it conducts business.

A member association of a federated cooperative, by changing its tax status, could also cause the federation to alter its tax status. The economic implications of such a situation would extend to all associations transacting business with the federation. In an extreme case, a local cooperative which changed its tax status could, through affecting a state federation's tax status, also affect a regional federation's status. Every member of a regional federation thus could be affected by one local association's change in tax status.

The effects of the *look through* concept, therefore, deserve careful attention by a cooperative contemplating changing its tax status. The economic gains derived by one cooperative from changing its tax status could be negated by the effects brought on by the *look through* concept. One example of this is the way in which patronage refunds and dividends are handled by the distributor and distributee.

SUMMARY

This research project investigated the federal income tax status of farmer cooperative associations engaged in marketing farm products and/or purchasing farm supplies. The project was undertaken to determine whether cooperativ associations maintaining exempt tax status have experienced economic advantages in relation to nonexempt status associations.

Through the investigation of 203 farmer cooperative marketing and supply associations in Ohio, it was found that 51 percent of those in the sample maintained exempt status in 1968. It was further determined that, in the same year, approximately 32 percent of all farmer cooperatives in Ohio maintained exempt tax status. Forty-three of the associations in the sample had changed their tax status at some time. Of that number, 75 percent had changed from exempt to nonexempt status.

Regarding the type of financial organization, no significant difference was found between exempt and nonexempt associations. Eighty-six percent of the exempt cooperatives were organized with capital stock, compared to 82 percent of those maintaining nonexempt status.

Differences were discovered between the exempt and nonexempt associations in size of membership, gross business volume, and nonmember business. Associations having the largest number of members and the largest business volume typically held exempt status. Forty-two percent of the exempt status organizations investigated had more than 1,000 members, compared to only 16 percent of the nonexempt cooperatives.

Three-fourths of the cooperative associations had gross business volumes less than $3 million annually. The percentage of exempt organizations with annual business volumes more than $6 million was twice as large as the percentage of nonexempt organizations.

More than 50 percent of the associations conducted more than 20 percent of their business volume with nonmembers. Exempt associations, it was found, typically conduct a smaller proportion of their business with nonmembers than do associations maintaining nonexempt status. Twenty-eight percent of the nonexempt organizations conduct more than 50 percent of their business with nonmembers.

The elevator associations investigated were homogeneous business operations in every way except tax status. Therefore, valid conclusions were arrived at from the financial analysis.

Using internal standards of comparison, it was found that the capital structures and operating ratios of both exempt and nonexempt elevators showed a weakening trend from 1950 to 1965. Comparison with selected industry standards showed that neither group was exceptionally strong in this respect.

By comparing the two groups with each other, relative strengths of the groups were determined. It was found that during the period investigated, total assets of the exempt elevators expanded at a much faster rate than total assets of the nonexempt group (Table 9). Therefore, the average size of exempt and nonexempt elevators became more nearly equal as time progressed (Table 8).

Both groups of elevators accomplished growth in total assets by substituting borrowed capital for owners' equity and by relying more heavily on semi-permanent forms of capital (Tables 10 and 13). The amount to which such substitution took place differed, however, for the two groups. The nonexempt elevators maintained owners' equity at more than 60 percent of total assets throughout the period investigated. Owners' equity in this group ranged between 67.1 percent and 61.2 percent of total assets from 1950 to 1965.

The exempt elevators decreased the owners' equity portion of total assets from 71.4 percent in

1950 to 59.2 percent in 1965. Owners' equity represented 56.8 percent of total assets in the exempt elevators in 1960, the lowest year. Therefore, from 1950 to 1965, the most important period for this analysis, owners' equity was maintained at higher and more stable levels by the nonexempt elevators. For these reasons, the nonexempt group was determined to be financially superior to the exempt group.

The nonexempt group also exhibited better overall performance than the exempt status elevators in the ten ratios used to measure profitability, liquidity, and asset use. Ratios calculated for the nonexempt group were generally higher than those of the exempt group. Five of the nonexempt elevators' ratios were within the selected industry standards throughout the period. One other, net worth to total debt, was within this range in both 1950 and 1965. Only four of the exempt status group's ratios were within the industry standards. Because of the differences noted, the nonexempt group was also determined to be superior to the exempt group in operational efficiency.

Based on both the balance sheet data and the operating ratios analyzed in this investigation, it was concluded that the nonexempt group of elevators experienced more economic success than the exempt group. This conclusion pertains to the years 1950 through 1965, a period during which the present exempt and nonexempt tax statuses were in effect.

Although the nonexempt status group of elevators experienced more economic success than the exempt status group during the period studied, it cannot be concluded that nonexemption is inherently more economically beneficial. Further investigation showed there was more variation between the ratios and capital structures of firms within the same tax status than there was between the aggregated ratios of the two groups. Some firms in each tax status were economically successful and some in each status were relatively unsuccessful economically.

Thus, on an individual firm basis, it cannot be concluded that economic success has been directly dependent on nonexempt tax status. Successful firms have maintained the more appropriate tax status for their particular type of organization and business operations.

CONCLUSIONS AND RECOMMENDATIONS

It is impossible to conclude unequivocally that one tax status is more economically advantageous than the other for all cooperatives. Both exempt and nonexempt status have inherent advantages for particular situations and certain cooperative associations. For nearly every cooperative association, one tax status is more economically advantageous than the other. Which tax status offers these benefits depends, however, on the organizational and operational characteristics of the particular association.

As concluded earlier, the factors determining which tax status is more economically advantageous for a particular association are:

1. Member - Nonmember Business
2. Type of Financial Organization
3. Non-Patronage Income
4. Size of Net Income and Tax Structure
5. Additional Business Opportunities
6. Effects on Other Cooperatives

Complete analysis of these factors reveals the major economic differences between the two tax statuses for a particular cooperative association.

A cooperative's geographical location, while not listed as one of the important characteristics to be considered, is a major underlying force in determining the more beneficial tax status. The location of a cooperative in relation to populous areas influences the amount of nonmember business and the additional business opportunities available. To the degree that these two factors are influenced by location, cooperative associations have unequal opportunities for capitalizing on them.

Certain nonmonetary factors must also be considered in a decision on tax status. Among the items listed in an association's articles of incorporation is the purpose for which the business was organized. Care must be exercised to insure that the association's stated purpose is not contradictory to operation under one of the tax statuses.

An association's bylaws must also be examined to determine if they affect the decision on tax status in any way. A competent lawyer's opinion might be required for exact interpretation in this area.

Members' viewpoints on tax status are perhaps the most important nonmonetary consideration. Viewpoints on tax status do not necessarily coincide with economic considerations. Therefore, members' viewpoints bear careful consideration on questions involving tax status. These factors must all be considered in an analysis of tax status as they form important constraints for decision making.

This study, as an initial research effort on exempt and nonexempt tax status, examined several aspects of the total question. Future research on this subject offers rewarding possibilities. It is recommended that future research efforts be directed toward developing a more refined and precise method of determining the tax status most beneficial to individual cooperative associations. A mathematical model, constructed to appraise the economic implications of the six factors discussed previously, would be extremely helpful to associations attempting to decide on the tax status with which to comply.

Through the course of this study, the authors concluded that decisions by farmer cooperative boards of directors on tax status have often been based on "rules of thumb" or certain specific points which do not adequately reflect the complete economic implications. These decision methods have mainly been utilized because of the complexity of tax status requirements. The question of tax status is too serious a matter to be decided by unsophisticated methods and rules of thumb. The dynamic, competitive economy in which farmer cooperatives operate today allows only a small margin for error. Therefore, it is recommended that boards of directors become knowledgeable on the subject of tax status. This includes learning about the requirements of each status and obtaining competent legal and technical personnel to aid in the ensuing analysis. Second, the directors and other cooperative leaders must approach the decision on tax status with the same economic objectives in mind that they use in deciding other operational matters. Only by taking these two steps can the most economical tax status for a particular association be determined.

APPENDIX A
INCOME TAX REGULATIONS GOVERNING FARMER COOPERATIVES

Exempt Cooperatives

Farmer cooperatives complying with Section 521 of the Internal Revenue Code of 1954 are known as *tax exempt* or *exempt* cooperatives. Such associations are taxed in accordance with the provisions of Subchapter T of the Internal Revenue Code.

By qualifying for exempt status, a farmer cooperative is entitled to three deductions from taxable income under Subchapter T: (1) patronage refunds and per-unit retain allocations, (2) dividends paid on capital stock, and (3) non-patronage income which is allocated to patrons on a patronage basis.[5] Thus, an exempt cooperative could conceivably have no taxable income after the three allowed deductions, provided all such amounts are paid or allocated in the proper form and within the proper time.

Exempt status farmer cooperatives have 8½ months following the close of their fiscal year to file their income tax returns. They must also satisfy the reporting requirement concerning payments of $10 or more to any person in any calendar year.

Section 521 of the Internal Revenue Code contains five requirements for exempt status. First, exemption applies only to "farmers, fruit growers or like associations organized and operated on a cooperative basis." The association must be a marketing and/or purchasing cooperative, ultimately turning back all net proceeds to member and nonmember patrons on the basis of quantity or value of business conducted by each with the association.[6]

Second, although exempt cooperatives are allowed to be organized with capital stock, the dividend rate on such stock must not exceed the legal rate in the state where incorporated or 8 percent per annum, whichever is greater. In addition, substantially all such stock (other than nonvoting preferred) must be owned by producers who market their products or purchase their supplies through the association.[7]

Third, reserves accumulated and maintained by an exempt association must either be required by state law or for a necessary purpose.[8]

Fourth, the value of products marketed by an exempt cooperative for nonmembers must not exceed the value of products marketed for members. Likewise, the value of supplies purchased for persons who are neither members nor producers must not exceed 15 percent of the value of all of the cooperative's purchases.[9]

Fifth, business done by a cooperative for the United States or any of its agencies is disregarded in determining an association's right to exempt status.[10]

Exempt status is granted by the Internal Revenue Service after application and is not automatic. An association applying for exempt status must file a Form 1028 (exemption application).

Exempt cooperatives are not permitted to file a consolidated tax return. Therefore, exempt status farmer cooperatives which own subsidiary corporations must file separate returns for each business enterprise. Nonexempt cooperatives may file a consolidated return if they so elect.[11]

Exempt status associations must afford equality of treatment to all patrons.[12] This requirement applies not only to patronage dividend distribution,[13] but to other activities as well.[14] Thus, an exempt status association is not permitted to discriminate between member and nonmember patrons in any way.

Nonexempt Cooperatives

A nonexempt status cooperative is a cooperative which does not satisfy the requirements set forth in Section 521 of the Internal Revenue Code of 1954.

[5]Internal Revenue Code of 1954, Sec. 1382 (c).
[6]Internal Revenue Code of 1954, Sec. 521 (b) (1).
[7]Internal Revenue Code of 1954, Sec. 521 (b) (2).
[8]Internal Revenue Code of 1954, Sec. 521 (b) (3).
[9]Internal Revenue Code of 1954, Sec. 521 (b) (4).
[10]Internal Revenue Code of 1954, Sec. 521 (b) (5).
[11]McCullough, William H. Cooperatives, Exempt or Nonexempt. Paper presented at Summer Session, American Institute of Cooperation, Blacksburg, Va., August 5, 1968, p. 21.
[12]Internal Revenue Code of 1954, Sec. 521 (b) (1).
[13]Treas. Reg. 1. 521 - 1 (a) (1).
[14]119 F. 2nd (8th Cir. 1941), Farmers Union Coop. Oil Co., 38 B.T.A. 64 (1938) and S. M. 2595, III-2 Cum. Bull. 238 (1924).

Broadly speaking, any organization not complying with Section 521 of the Code holds nonexempt status. For purposes of federal income taxation, a nonexempt organization need not be agriculturally oriented, nor is it even required to be legally organized as a farmer cooperative.

Nonexempt status farmer cooperatives are subject to regular corporate income taxes with one exception. If they qualify under Subchapter T of the Internal Revenue Code of 1954, their patronage refunds and per-unit retain allocations are deductible from taxable income. To be deductible, these amounts must be allocated to patrons on a patronage basis.

To qualify for Subchapter T, a nonexempt association must "be operating on a cooperative basis and allocate amounts to patrons on the basis of the business done with or for such patrons."[15] Subchapter T clearly recognizes nonexempt associations.[16] Prior to enactment of Subchapter T in 1962, the only statutory reference to nonexempt organization was oblique.

For purposes of federal income taxation, nonexempt organizations, unlike those maintaining exempt status, are under no limitations concerning stock ownership, dividend rates, membership, or business transactions with nonmembers. The only requirements a nonexempt cooperative must satisfy are those imposed by the statutes under which it is incorporated. Since corporate statutes are under state jurisdiction, these statutes are not necessarily uniform throughout the United States.

Since a nonexempt cooperative is not required to treat all patrons equally, a nonexempt cooperative can make patronage refund distributions to members only. This practice is recognized by the Internal Revenue Service. Any income from business with nonmembers is taxable to the nonexempt cooperative unless properly allocated to the nonmembers.[17]

Nonexempt cooperatives are required to file their income tax returns within 3½ months following the end of their fiscal year. They are permitted 8½ months for this purpose only if they are under obligation to allocate or pay at least 50 percent of their net patronage earnings in patronage dividends, or if they have actually allocated or paid at least that percentage of their earnings in patronage dividends during the last year in which they had such earnings.[18]

[15]Treas. Reg. 1.1381 - 1 (2).
[16]Treas. Reg. 1.1388 - 1 (a) (2).
[17]Treas. Reg. 1.1388 - 1 (a) (2) (ii).
[18]Mischler, Raymond J. 1962. How the Revenue Act of 1962 Affects Farmer Cooperatives. U. S. Dept. of Agriculture, Farmer Cooperative Service, General Report 105, pp. 4-5.

APPENDIX B
FINANCIAL TERMS USED IN STUDY

The analysis and interpretation of financial data require a comprehensive understanding of financial terminology. Many of the financial terms used in connection with farmer cooperatives have different meanings to different people.

The following are definitions of financial terms used in this study.

Net Worth: Net worth or owners' equity is the excess of the value of assets over liabilities. It represents the ownership interest in a business firm.

Net worth, as used in this study, consisted of the firm's permanent and semi-permanent forms of capital. Thus, net worth was comprised of: (1) common stock, (2) preferred stock, (3) unallocated reserves, (4) book allocations, (5) allocated reserves, (6) certificates without maturity dates, and (7) membership capital.

Liabilities: Liabilities are amounts owed by a business firm to its creditors. Total liabilities include current liabilities and term liabilities. Obligations due within 1 year are current liabilities. Term liabilities are obligations which become due more than a year from the date of the balance sheet.

Total liabilities, as used in this study, included: (1) secured and unsecured current liabilities, (2) all term liabilities, such as mortgages payable and notes payable, and (3) firms' non-permanent forms of capital. Debenture bonds and certificates with maturity dates comprised the non-permanent forms of capital.

Non-permanent forms of capital are classified as net worth by many farmer cooperatives. They were classified as liabilities for this study, however, as they possess a definite due date and are usually interest bearing.

Capital Stock: Capital stock refers to the securities issued by a corporation as shares of ownership. The two types of stock are common and preferred. Each type can be divided into several classes in order to control voting rights, attract the maximum amount of investment capital, and vary income and risks of stockholders.

Common stockholders are the residual claimants of the corporation. They are the last to receive dividends and proceeds from dissolution. Common stockholders assume greater risks than either preferred stockholders or creditors.

Preferred stock is preferred over the common stock in respect to dividends. It may also be preferred over common in respect to assets upon dissolution. This type of stock must have a specified dividend rate since it is entitled to this amount before dividends can be declared on common stock. The voting rights of preferred stockholders are usually restricted in some way.

Unallocated Reserves: Unallocated reserves are amounts set aside from net margins or net savings to be kept in the business permanently. These equity reserves are not subject to allocation to patrons or members of a cooperative. Federal income taxes have been paid by the cooperative on unallocated reserves. Various names used for these reserves are: general reserves, earned surplus, tax-paid surplus, capital reserves, and retained earnings.

Membership Capital: Membership capital is the amount which has been paid by individuals for membership in a nonstock or unincorporated cooperative. A membership certificate is often issued as evidence that the membership fee has been paid. Some membership certificates grant voting rights and others do not.

Allocated Reserves: Allocated reserves are amounts of patronage refunds which have been allocated to patrons of a cooperative but retained in the business for an indefinite time period. Certificates showing the amount of retainage are issued to patrons who have funds in such a reserve.

Amounts retained in this way are taxed in accordance with Subchapter T of the Internal Revenue Code of 1954. Either the cooperative or the patron, but not both, is required to pay the federal income tax on funds retained in allocated reserves. The burden of taxation depends on the form and time in which allocations are made.

Book Allocations: Book allocations are also amounts of patronage refunds retained in the business. The method of allocation, however, is different than for allocated reserves. Amounts retained in this manner are allocated to the individual patron's account on the books of the cooperative. No certificates are issued but patrons are notified by letter of the amount credited to their capital account. Funds retained by this method are taxed the same way as allocated reserves.

Certificates Without Maturity Dates: These certificates represent deferred patronage refunds payable in cash at some future date. No date for redemption is specified. The amounts represented by these certificates may represent per-unit retain allocations as well as patronage refunds. Certificates without maturity dates are a semi-permanent form of capital. In some instances, interest is paid to holders of these certificates. Certificates of this type are normally called certificates of ownership or certificates of equity.

Certificates With Maturity Dates: These certificates possess a definite maturity or due date. Maturity-dated certificates are issued to represent per-unit retains, retention of patronage refunds, or outright purchase. Various names used for these certificates are: certificates of indebtedness, revolving fund certificates, participation certificates, and certificates of interest. In this study, certificates with maturity dates were classified as a non-permanent form of capital. As such, they were part of total liabilities rather than net worth.

Debenture Bonds: Debenture bonds have a fixed rate of interest and a fixed maturity date. They are secured only by the general credit of the issuing company and thus have no claim on specific property. Debenture bonds and certificates with maturity dates are essentially the same type of unsecured debt capital.

Per-Unit Retains: The per-unit retain or capital retain method of acquiring capital is used primarily by marketing cooperatives. Per-unit retains refer to investments made by patrons of farmer cooperatives based on the physical or dollar volume of products marketed through the cooperatives. The amount to be retained is normally deducted from the price a patron receives for his product. This method of acquiring capital causes patrons to contribute capital in proportion to their use of the cooperative.

Permanent Capital: For purposes of the study, common stock, preferred stock, and surplus were considered permanent capital. Redemption of these forms of capital is normally at the board of directors' discretion, subject to the bylaws of the organization.

Semi-Permanent Capital: Book allocations, allocated reserves, certificates without maturity dates, and membership capital are considered semi-permanent forms of capital. Technically, organizations are obligated to repay these forms of capital, but the date for redemption is a board of directors' decision. Therefore, these forms could be made relatively permanent.

Non-Permanent Capital: Forms of non-permanent capital are bonds and certificates possessing a fixed rate of interest and a definite maturity date. These forms of capital are normally considered long-term liabilities which compete directly with an organization's other sources of external capital.

APPENDIX C
OPERATING RATIOS USED IN STUDY

The *current ratio* is computed by dividing total current assets by total current liabilities. This ratio gives some measure of a firm's liquidity. It shows the margin of safety of the company with regard to payment of its short-term liabilities. What constitutes an adequate current ratio varies according to the industry, season of the year, and expansion activities of the firm.

Total receivables of current assets is obtained by dividing total receivables by current assets. This ratio is also a measure of liquidity, showing the proportion of current assets carried on the credit books. In this study, total receivables included notes receivable, accounts receivable, and miscellaneous receivables.

Net supply sales to total receivables reflects the turnover of receivables. This ratio is computed by dividing net supply sales by the customer receivables outstanding. Firms can utilize this ratio in measuring the efficiency of their credit program and in judging the quality of receivables. Receivables turnover is also an effective control measure for controlling receivables.

Age of total receivables is computed by dividing the net supply sales to total receivables ratio into 365 days. This computation gives the average number of days' sales which are outstanding. When a firm's credit policy is known, age of total receivables shows the effectiveness of the firm's collection policy. Thus, age of total receivables is another useful measure for controlling accounts receivable.

Net worth to total debt, otherwise known as the *equity ratio,* is obtained by dividing net worth by total liabilities. This ratio reflects the proportion of total assets financed with borrowed funds and the proportion financed with ownership funds. The amount of financial leverage used by a firm is also reflected in the net worth to total debt ratio. Both owners and creditors are interested in this ratio as it indicates the safety margin of their investment.

Total expenses to net sales or the *expense rate* is computed by dividing total expenses by net sales. The *expense rate* affects the margins which must be achieved in order to realize a profit on sales. This ratio normally varies with the level of sales due to the fixed nature of certain expenses. Thus, the *expense rate* reflects management's efficiency in selling activities.

Net savinngs to net sales is commonly referred to as *profit margin.* It is computed by dividing net savings by net sales. Net savings is the net margin before federal income taxes, stock dividends, and patronage refunds have been deducted. This ratio measures the profitability of a firm's sales.

The *net sales to total assets ratio* or *asset turnover* is found by dividing total assets into net sales. This ratio reflects the productivity of total assets. By comparing this ratio over several years, an individual firm can discover tendencies to over-invest or under-invest in total assets.

Net savings to total assets is commonly used to express return on investment. This ratio is found by dividing net savings by total assets. Profitability of total assets is not clearly shown by this ratio, however, as payments to borrowed capital are deducted as a business expense. To properly represent the return to all assets used in the business, interest payments must be added to net savings before the ratio is computed.

The net savings to total assets ratio can also be found by multiplying *net savings to total sales* by *net sales to total assets.* This method of calculation shows clearly the two factors affecting return on investment. Return on investment can be increased by increasing either *profit margin* or *asset turnover.*

Net savings to net worth shows the return to funds invested in a business by the owners. This ratio is computed by dividing net savings by net worth (owners' equity). If borrowed capital is used to finance part of a firm's assets, return to net worth will be different from return to total assets. The amount of this difference depends on the proportion of debt and equity capital used in the business.

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Center Headquarters, Wooster, Wayne County: 1953 acres

Eastern Ohio Resource Development Center, Caldwell, Noble County: 2053 acres

Jackson Branch, Jackson, Jackson County: 344 acres

Mahoning County Farm, Canfield: 275 acres

Muck Crops Branch, Willard, Huron County: 15 acres

North Central Branch, Vickery, Erie County: 335 acres

Northwestern Branch, Hoytville, Wood County: 247 acres

Southeastern Branch, Carpenter, Meigs County: 330 acres

Southern Branch, Ripley, Brown County: 275 acres

Western Branch, South Charleston, Clark County: 428 acres